

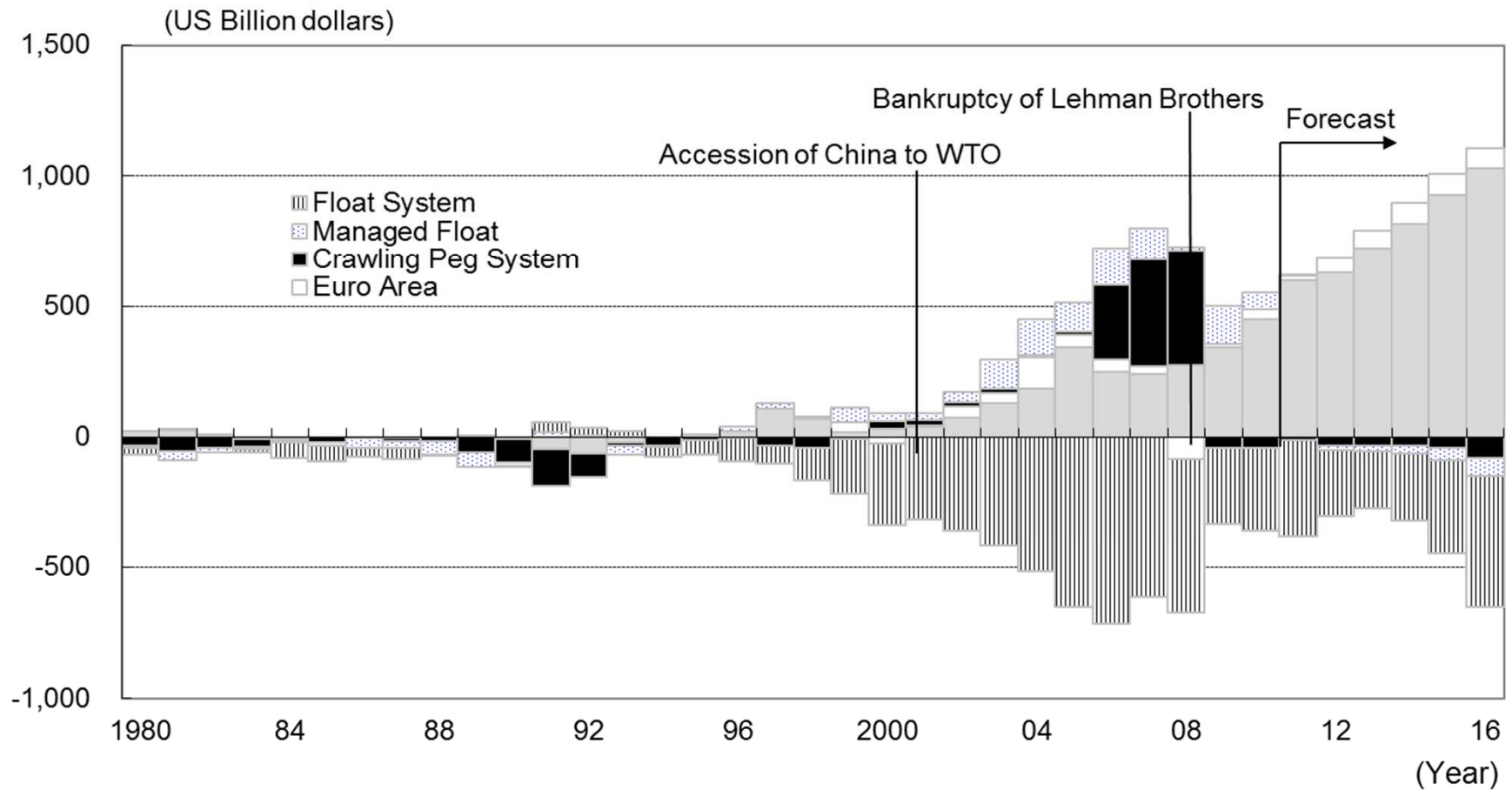
# Distortions in Macroeconomic Framework and Exit Strategies

“Fragmentation in the International Financial System  
: Can the Global Economy Become One Again?”  
The Central Bank of Turkey and Reinventing Bretton  
Woods Committee  
July 14, 2012  
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President, Japan Center for Economic Research

# 1. Global Macroeconomic Trend

1. Global economy is in a process of simultaneous slowdown, as shown by recent weak developments of PMI and ISM.
  - US and Japan will grow by 2%, while the Euro area will register negative rate of growth in 2012.
  - China and India will decelerate growth rates down to below 8% and 6% respectively.
2. On financial market the “existential crisis of euro” is one of the most serious factors which will destabilize exchange rates of major currencies and global financial system.
3. The current account imbalance persists in global economy.
  - it widened within the euro area.

# Fig.1 Current Account Balance Classified by Exchange Rate System



(Source) Japan Center for Economic Research

## 2. Distortions of Macroeconomic Framework after the Lehman's Collapse

1. After the Lehman's collapse extremely expansionary monetary/fiscal policies were adopted by major advanced economies to prevent free-fall of economic activity and ward off the risk of deflation.
2. In a process of deleveraging by financial institutions, balance sheets problem was shifted from private sector to government and central banks.
3. Excessive accumulation of government debt has intensified the risk of sovereign debt default in advanced economies.
  - Yet, in current global financial system, there exists "non-system" to manage sovereign debt crisis (United Nations(2009))
  - Shortage of safe asset will become acute, since safe public debt will decrease by \$9 trillion in 2016 (IMF(2012)), because of the higher sovereign debt default risk (CDS spreads above 200).
  - Government bond markets are "fragmented , less liquid , and more reliant on domestic investors with increasing intermediation costs"(IMF(2012)).

## 2. Distortions of Macroeconomic Framework after the Lehman's Collapse

4. In Euro area we observe the combination of two crises and the risk of contagion to Italy and France.

(1) sovereign debt crisis (notably, Greece)

(2) financial crisis (notably, Ireland, Spain, Cyprus)

5. Potential sovereign debt risk looms large in other advanced economies:

US: “relatively clean dirty shirts” with future debt amounting to 66 trillion (B.Gross)

Japan: risk of explosion of government debt despite the recent decision of 5% increase in consumption tax rate

UK: austerity fiscal measures undermining recovery process

## 2. Distortions of Macroeconomic Framework after the Lehman's Collapse

6. Further we see unusual expansion of balance sheets in major central banks.
  - Its spillover effect on emerging economies aroused the concern of currency wars or the “beggar-thy-neighborhood effects”.
  - But we should not dismiss the effect of improvement of the terms of trade and lower world real interest rate on economic welfare of trading partner countries.
  - There is a possibility of the “beggar-thyself effect” if the terms of trade worsens above certain threshold.
  - Emerging economies accumulate foreign reserves to insure against wide fluctuation of exchange rate and terms of trade. It incurred significant costs due to the interest rate differential and expansion of balance sheets of central banks with concomitant inflation risk.

## 2. Distortions of Macroeconomic Framework after the Lehman's Collapse

7. Major international reserve currencies including dollar and the euro have shown a large scale decline in external values.
  - Large fluctuation of major reserve currencies took place against the background of the tectonic shift of relative economic power to Asia and financial crisis in advanced economies (Table 1,2).
8. In the euro zone, there exists not only widening current account imbalance due to the misalignment of real effective exchange rates among member countries, but also deposits imbalance;
  - Two imbalances led to payment imbalance (Target 2) indicating the financial fragility and mutual distrust in the Euro banking system (Fig.2)
  - Bundesbank is being sued by a German lawyer who claims against its use of taxpayers' money through the Target 2 payments system.

Table 1. Large-Scale Depreciation of Effective Exchange Rate and Contemporary Change in Terms of Trade

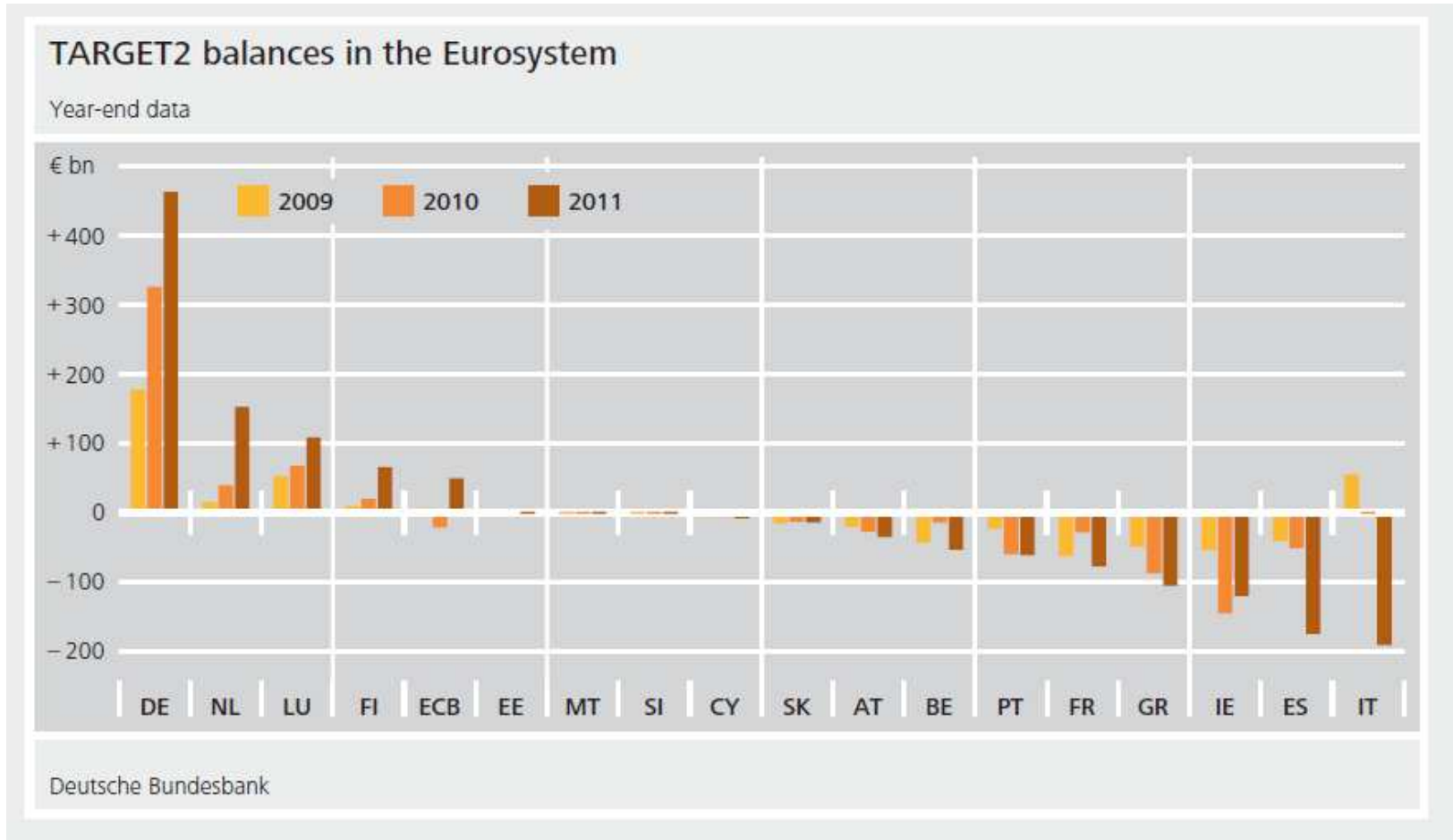
	US		Euro	Germany		UK	
1970Q1 -1973Q3	-20%	-7.8%					
1985Q1 -1988Q2	-53%	-2.2%					
1990Q4 -1996Q1						-24%	-0.9%
2002Q1 -2011Q3	-55%	-12%					
2007Q1 -2011Q3						-33%	+0.1%
2009Q3 -2011Q3			-7.1%	-4.3%	-8.7%		
			-9.5%	-6.4%			
Nominal Effective Rate	Terms of Trade						
Real Effective Rate							



Table 2. Large-Scale Appreciation of Effective Exchange Rate and Contemporary Change in Terms of Trade

	Japan		Switzerland
	Effective Exchange Rate	Terms of Trade	Effective Exchange Rate
1990Q2 -1995Q2	+45% (Nominal) +38% (Real)	-1.9% (Total) +1.1% (excluding Oil, Coal and Natural Gas)	
2007Q2 -2011Q3	+34% (Nominal) +27% (Real)	-27.5% (Total) -6.0% (excluding Oil, Coal and Natural Gas)	+30% (Nominal) +25% (Real)

# Fig.2 Liability and Asset at Target II

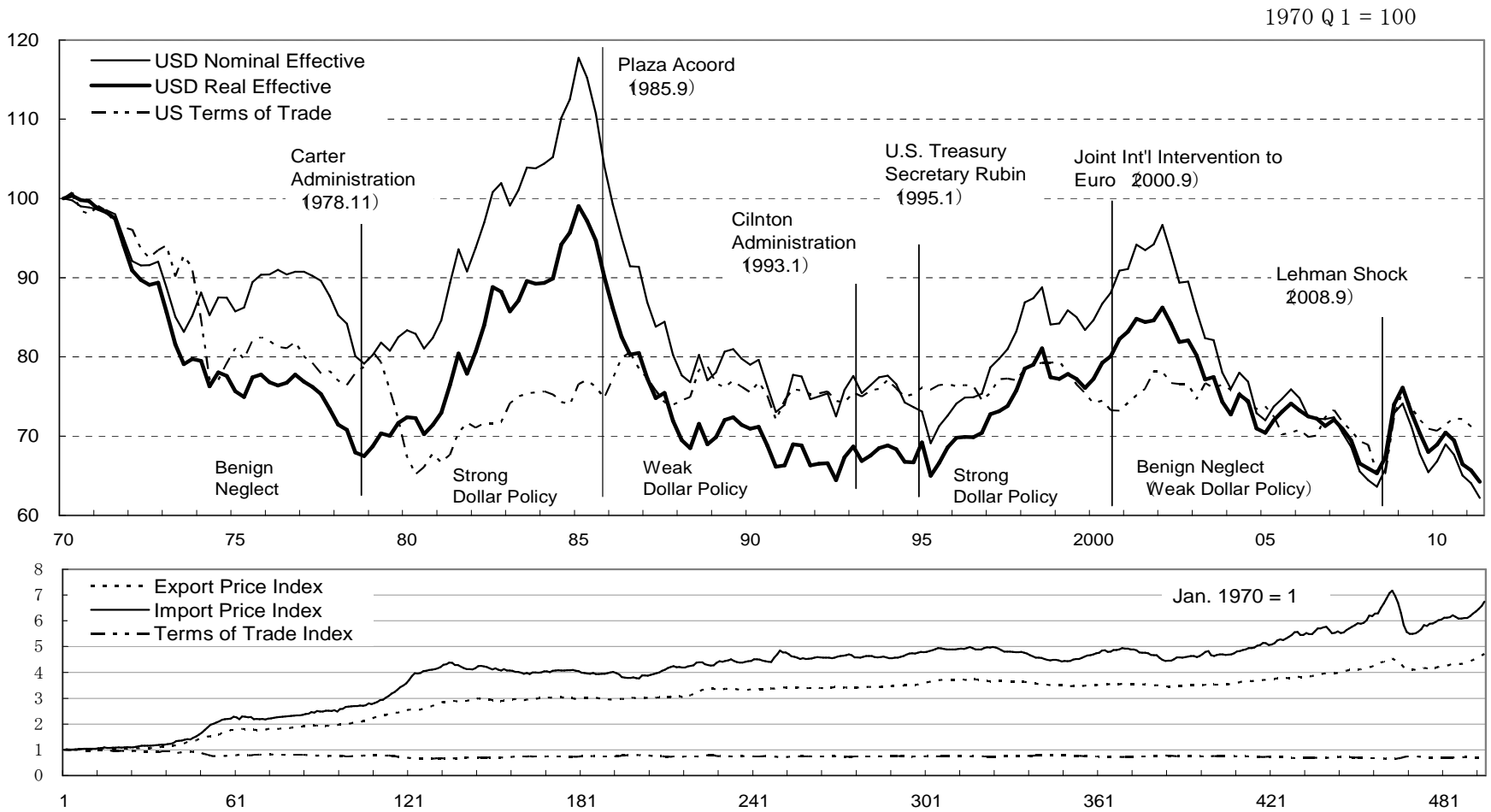


(Source) Deutsche Bundesbank , Annual Report 2011

## 2. Distortions of Macroeconomic Framework after the Lehman's Collapse

- There is a risk of currency crash or break-up of the euro.
- nominal effective Euro rate depreciated by 7 % in the period from Q3 2009 to Q3 2011, while real effective rate declined by 9 . 5 % (Table 1).
- Nominal effective US dollar rate depreciated by 55% in the period from Q2 2002 to Q3 2011, while real effective rate declined by 3 3 % (Table 1, Fig.3).
- There is a risk of contagion effect arising from euro's existential crisis to US and Japan, given the fragmented politics on the issue of budget deficit reduction and future debt.

# Fig. 3 Effective Exchange Rate (US)



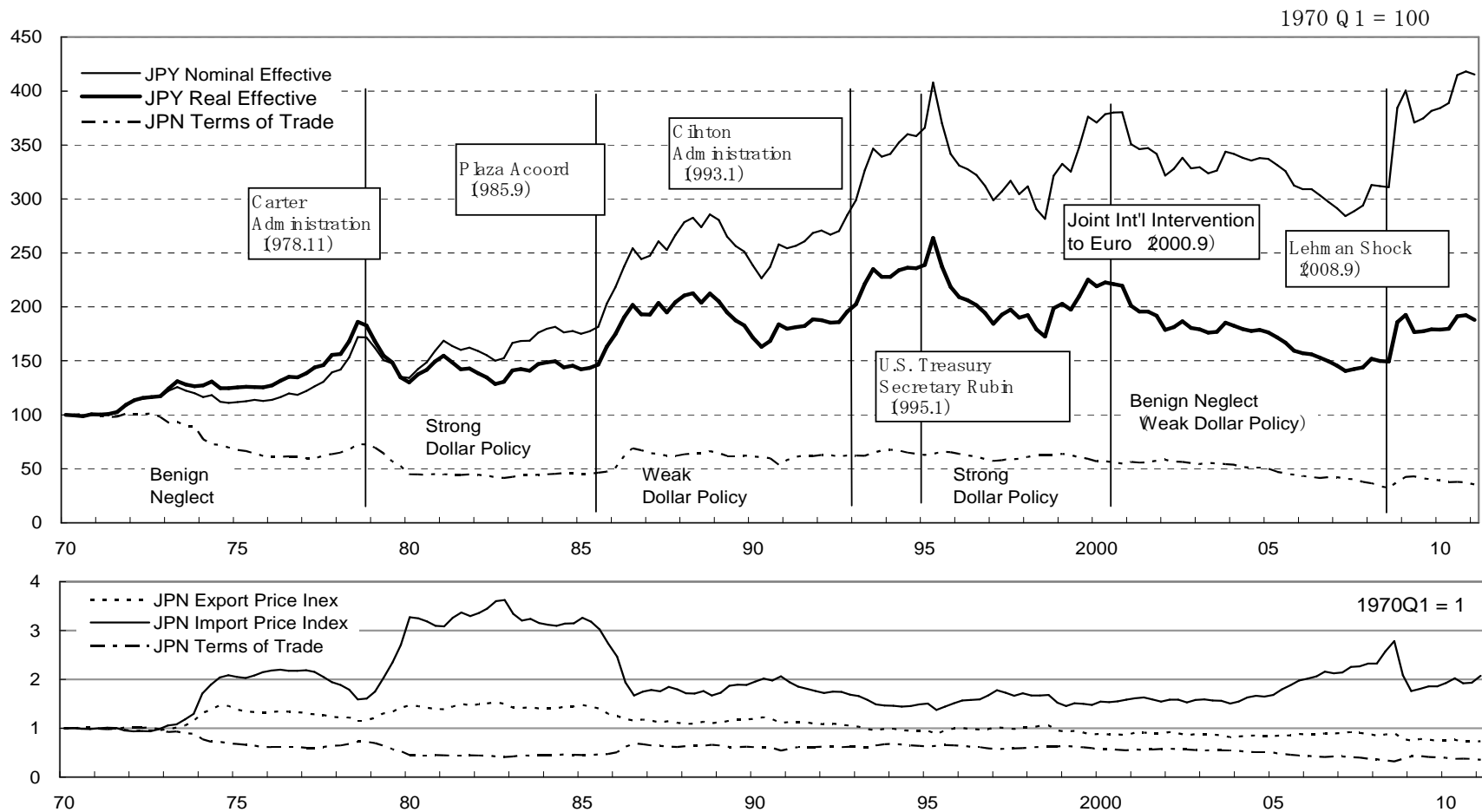
Source) Bank of International Settlement, *The BIS Effective Exchange Rate Indices*; Bureau of Labor Statistics, *Import and Export Price Indexes*

(Year)

## 2. Distortions of Macroeconomic Framework after the Lehman's Collapse

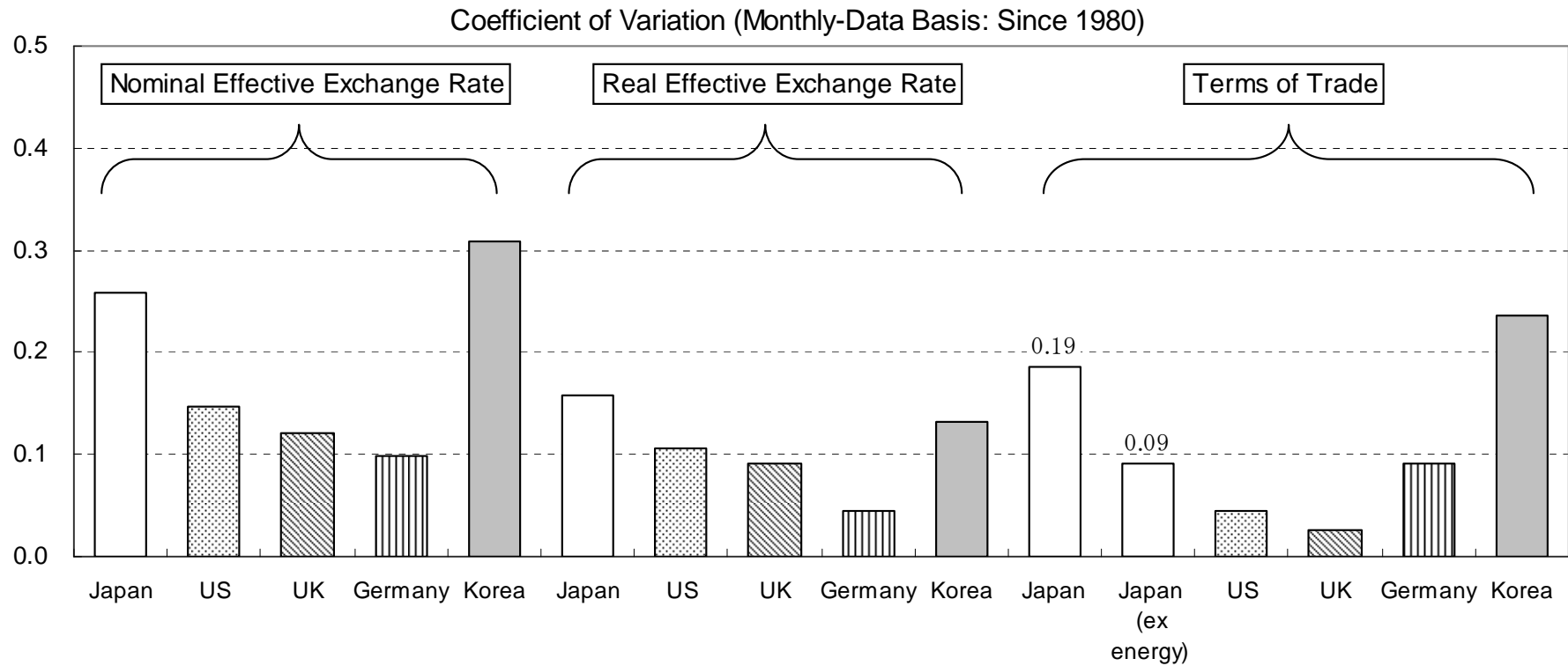
8. After the Lehman's bankruptcy, Yen coupled with Swiss Franc has been chosen as a flight currency, despite the weak fundamentals (six plights of Japanese firms) (Table 2, Fig.4), resulting in excessive volatility and appreciation of Yen in view of overcoming persistent deflation (see, Note) (Fig.5).
- In sharp contrast, real effective German Mark rate has been surprisingly stable since 1970 (Fig.6).
  - The difference created remarkable divergence on export performance (Fig.7).

# Fig.4 Effective Exchange Rate (Japan)



Source) Bank of International Settlement, *The BIS Effective Exchange Rate Indices*; Bank of Japan, *Corporate Price Index*

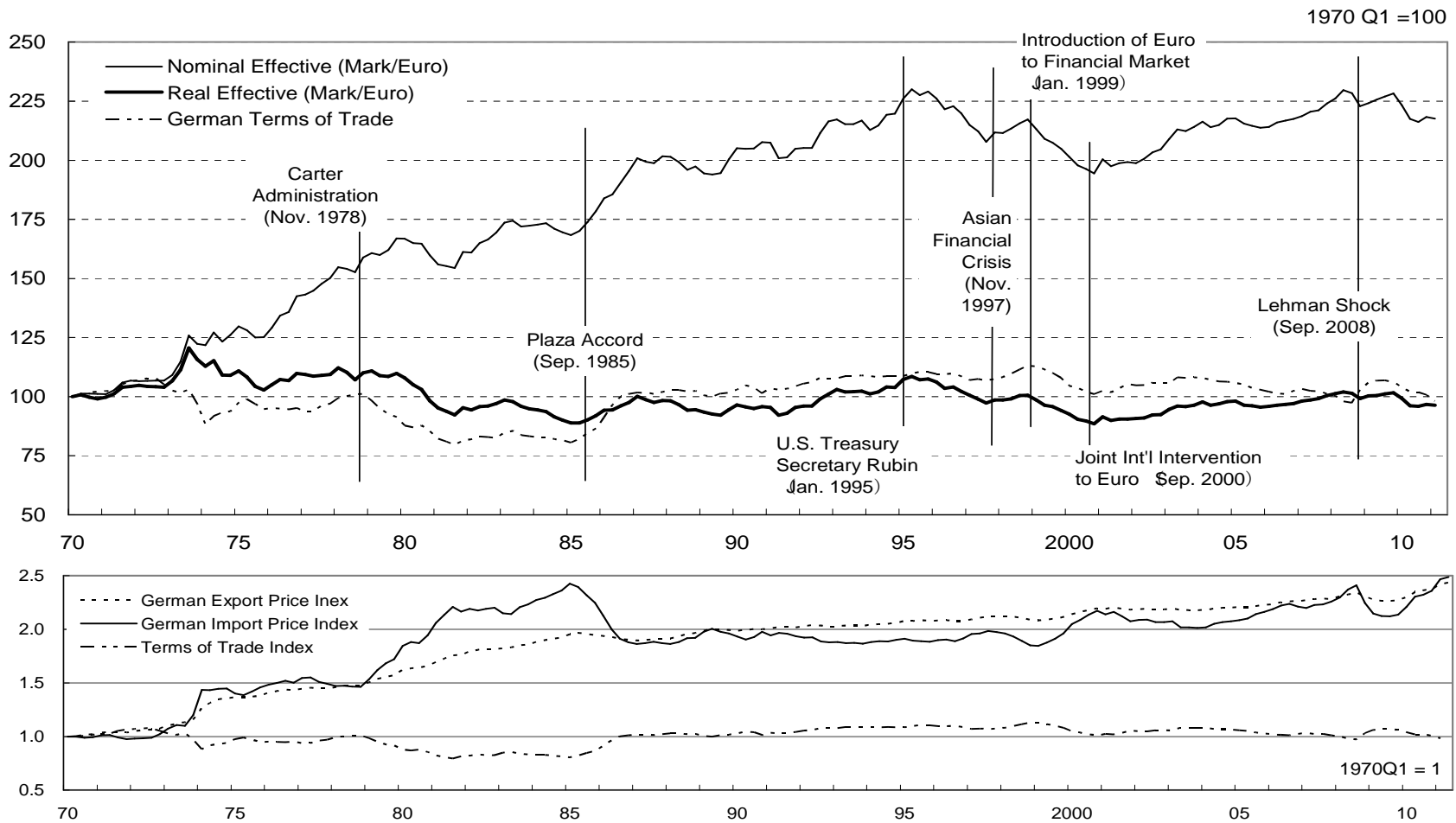
# Fig.5 Effective Exchange Rate and Terms of Trade



(Note) Japan, US, Germany: Jan. 1980 through Sep. 2011; UK: Jan. 1980 through July 2011; Korea: Jan. 1980 through Sep. 2011

(Source) Bank of Japan, Corporate Goods Price Index (Year 2005 Base), International Monetary Fund, *International Financial Statistics*

# Fig. 6 Effective Exchange Rate (Germany)

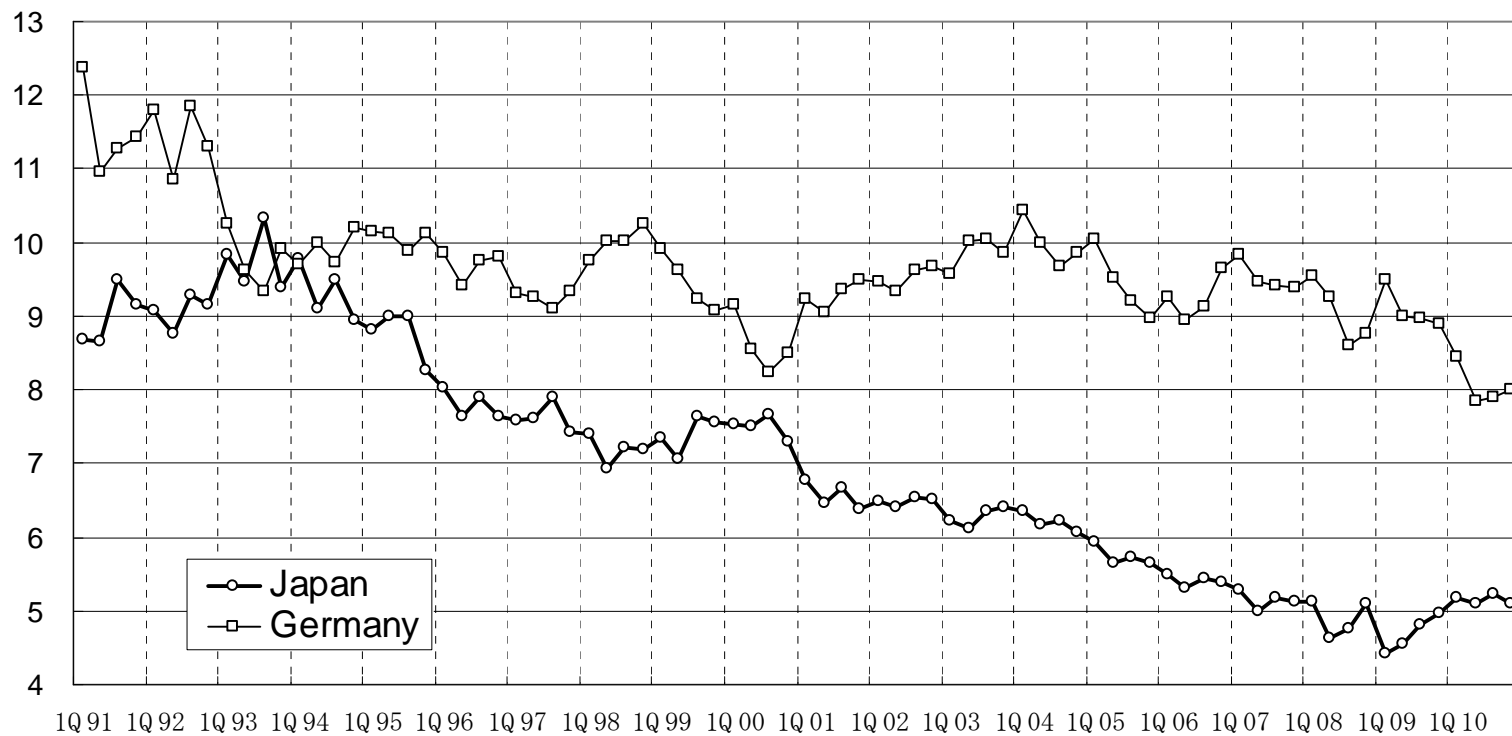


Source) Bank of International Settlement, *The BIS Effective Exchange Rate Indices*; International Monetary Fund, *International Financial Statistics* (Year)



# Fig.7 Export Shares of Japan and Germany

The Shares in the World Export Value in Total (%): Japan and Germany



(Note) The values are measured in the US dollars.

Quarter/Year)

Source) International Monetary Fund *Direction of Trade Statistics*

# 3. Exit Strategies from the Existential Crisis of Euro

- 1 . The EU summit in 28/29 June endorsed a “Compact for Growth and Jobs,” while announcing a number of short-term measures which address the lack of lender of last resort for the Eurozone and the support to recapitalize undercapitalized banks;
  - namely, it was decided to implement the purchase of government bonds and direct capital injection to Spanish banks by EFSF/ESM and establish a single supervisory mechanism involving the ECB.
2. Yet, there remains technical details and issues to be cleared for implementing these measures.

## 4. Exit Strategies from the Existential Crisis of Euro

3. In the euro area it is needed to establish the banking union (unified supervision authority, common deposit insurance and resolution fund) while introducing the euro bonds.
  - Yet, Germany wants to have fiscal/political union before committing to mutualization of risk through the Target 2, banking union and euro-bonds (based on coronation approach which was adopted by Germany before introducing monetary union).

# 5.Exit Strategies from Global Financial Crisis

1. Despite the efforts by government and central banks to stabilize global financial system by removing distortions, “we are not yet half way through the crisis” (Governor King).
  - Appropriate macro-economic framework is absent to stop the contagion of systemic financial risks.
2. In order to prevent the contagion of crisis to world economy and stabilize the external value of major currencies, I made proposal at the National Strategy Council at the end-October last year.

# 5. Exit Strategies from Global Financial Crisis

- (1) Establishing the fund to enable the purchase of foreign bonds amounting to \50 trillion; its loss is indemnified by the Ministry of Finance
- (2) Doubling the size of IMF loan base from \$750 billion to \$1.5 trillion to strengthen the global financial safety network.
- (3) Creating a new committee within IMF to discuss “global macro-prudential policy” and preventive measures against contagion of crisis and to secure the stability of values of major currencies.

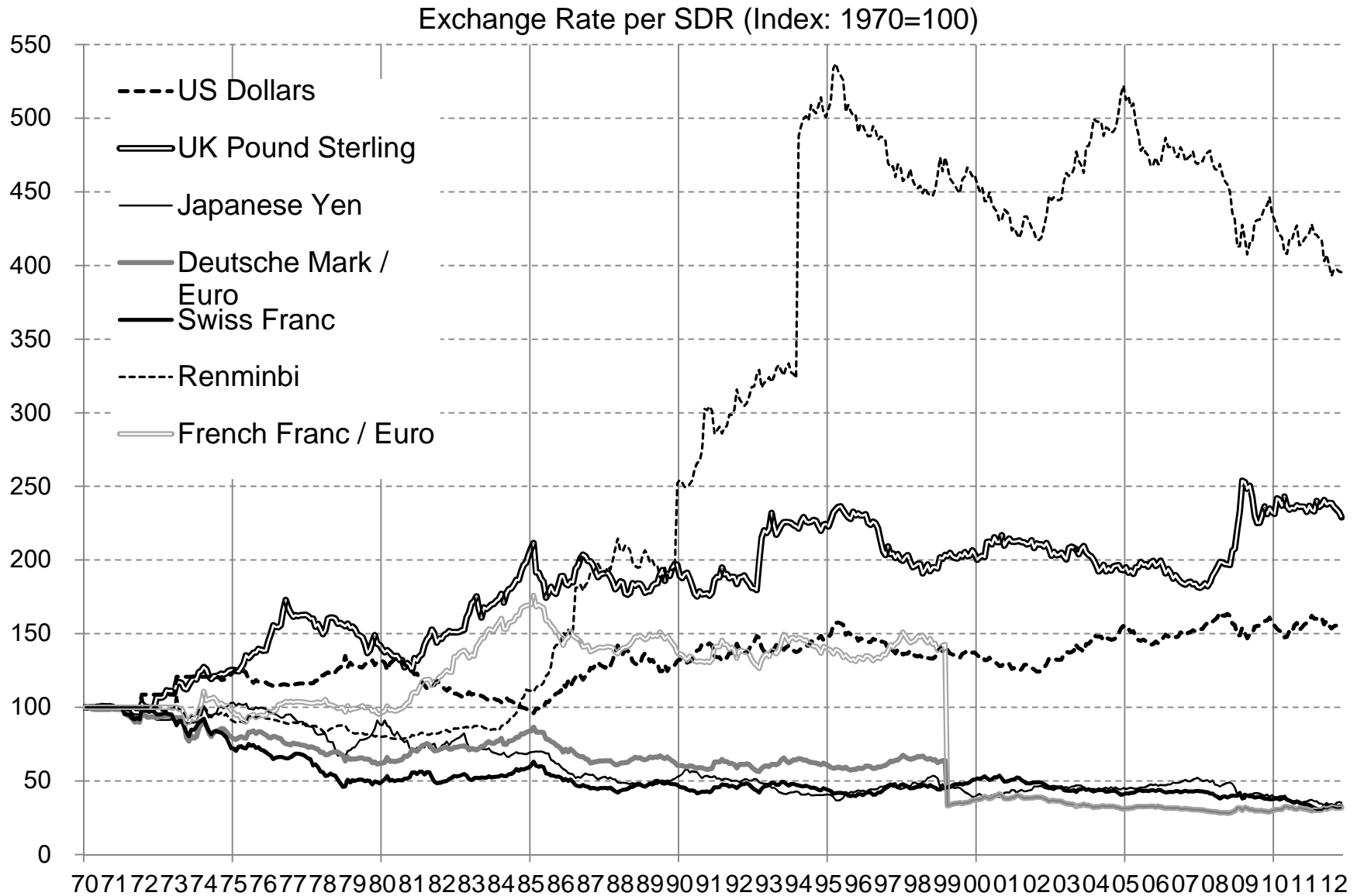
# 5. Exit Strategies from Global Financial Crisis

3. To prevent the liquidity crisis, it is needed to establish more solid international financial safety net:
  - Strengthen the linkage between the IMF lending (Flexible Credit Line, and Precautionary and Liquidity Line), the Chiang Mai Fund and the central banks' swap arrangements. IMF should play the role of coordinating these arrangements and programs.
4. It is worthwhile reconsidering a new role of central banking for global financial stability and macro-prudential policy , taking into account international spillover effect.
  - Macro-prudential policy comprises the stabilization of capital flows in emerging/developing countries.

# 5. Exit Strategies from Global Financial Crisis

5. Given the shortage of safe assets in coming years, it is desirable to issue the high quality safe assets, for instance, SDR-denominated IMF bonds(Lago, Duttagupta and Goyal(2009)).
- This serves to enlarge the emergency loan base of IMF and accommodate the demand for safe assets.
  - It will serve to stabilize the external value of major currencies in terms of SDR(Fig.8), if the SDR denominated financial instruments were issued by other multilateral institutions and private sectors and employed as reserve assets by central banks.

# Fig.8 Exchange Rates in Terms of SDR



(Source) International Monetary Fund, *International Financial Statistics*.

(Year)



# 5. Exit Strategies from Global Financial Crisis

6. Advanced economies face both the “fiscal and monetary cliff” after the expansion of budget deficits and balance sheets expansion of central banks.

-On the fiscal cliff, there are two different views; “self-defeating austerity” and “expansionary contraction” , in the face of limited fiscal space.

-Credible commitments to future cut in spending or tax increase combined with tax-social security reform will mitigate the two conflicting views.

# 5. Exit Strategies from Global Financial Crisis

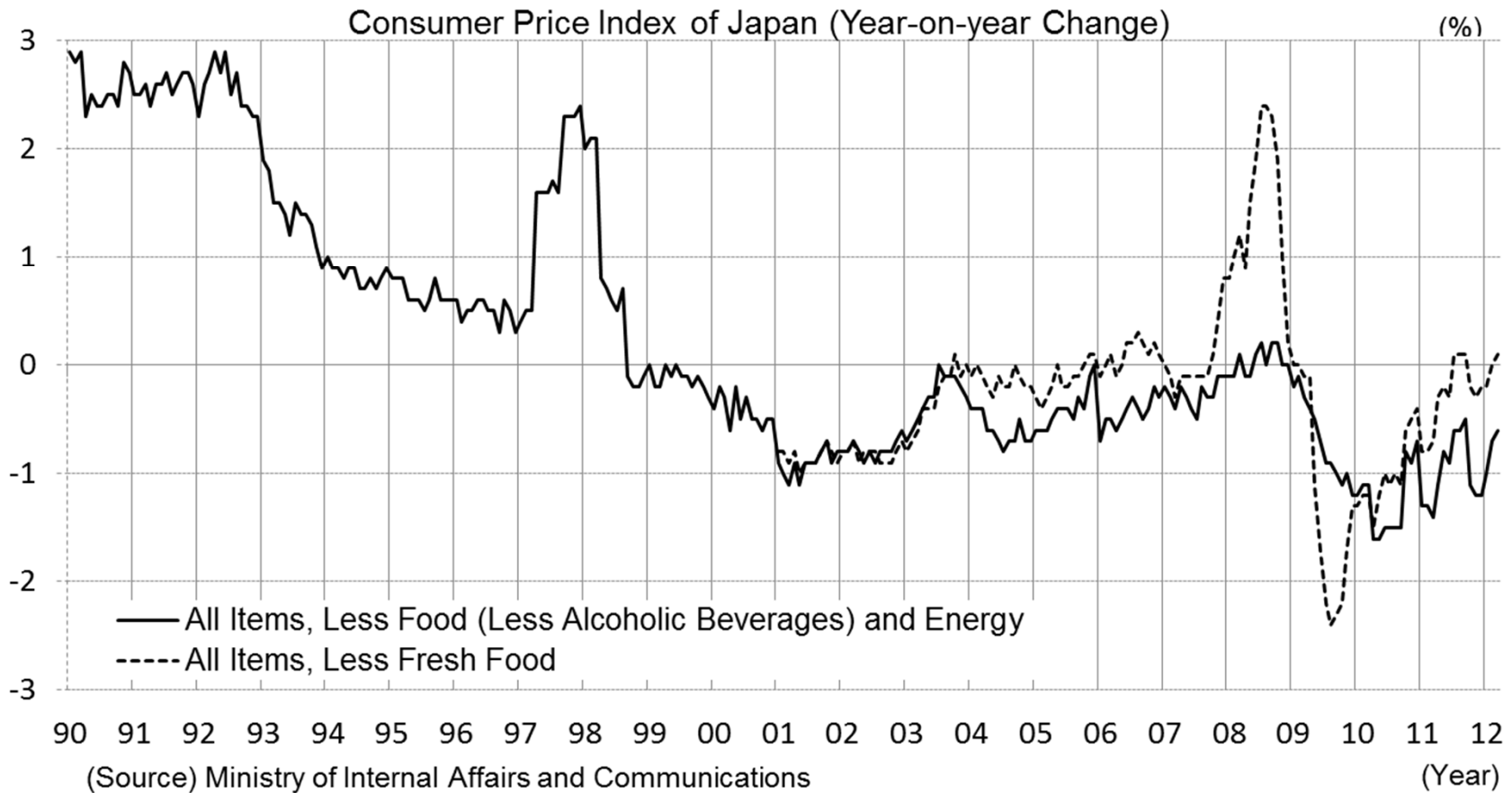
7. On the exit of QEs or CEs of expansionary monetary policy, we need the transparency of exit process.

-BOJ's exit from QE 1(2003-2006) caused no big adverse impact on market, because of the clear commitment to exit conditions.

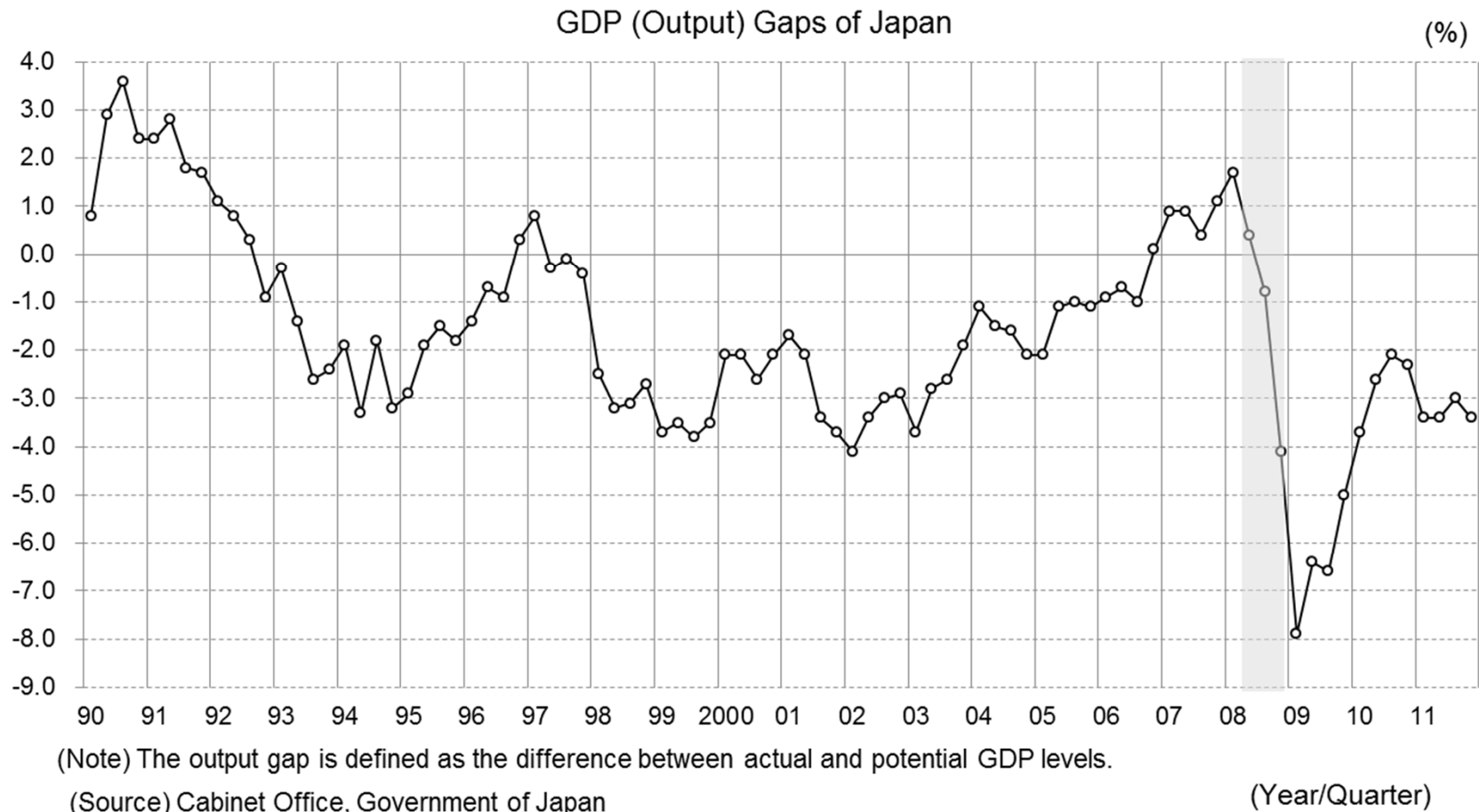
-In Japan, it is too early to talk about exist from QE's, because it is still difficult to foresee 1% inflation rate in the forecast horizon, similar to the ECB, the BOE and the Federal Reserve(Fig.9,10,11).

-The interest rate on bank reserve will make the exit process more easily by separating the liquidity provision management from changes in policy rates.

# Fig.9 Consumer Price

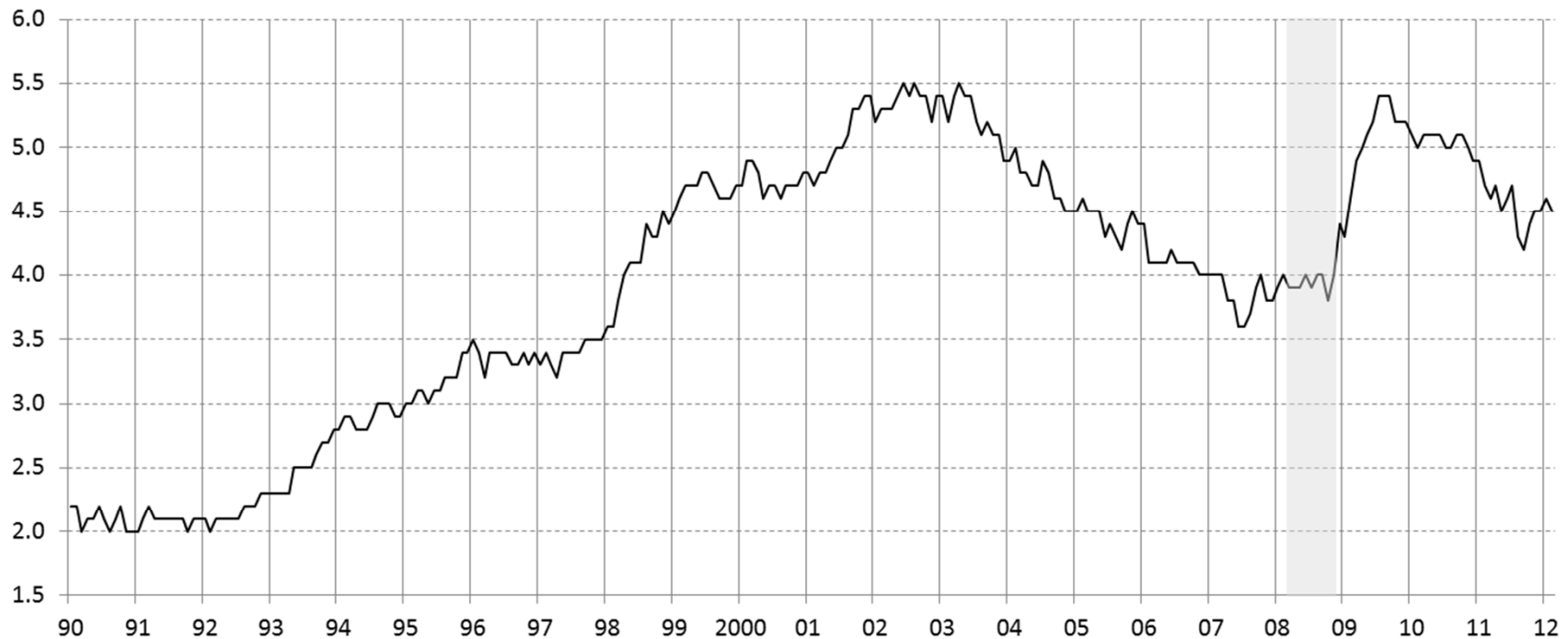


# Fig.10 Output Gap



# Fig.11 Unemployment Rate

Unemployment Rate, Whole Japan (Seasonally Adjusted)



(Source) Ministry of Internal Affairs and Communications, *Labour Force Survey*

(Year)

(Caution) The figures from March to August in 2011 does not cover the prefectures heavily damaged by the Great East Japan Earthquake, including Iwate, Miyagi and Fukushima.

# 5. Exit Strategies from Global Financial Crisis

8. We should recognize that the global imbalance is associated with choice in exchange rate system (Fig.1).

-At the same time, global imbalance can be interpreted as distorted distribution of high quality assets between the US and Asia (“total return swap arrangement” with the de facto dollar-pegged system by Asian countries under Bretton Woods II) (Table 3, Fig.10).

-It is needed to promote the development of Asian bond market through creation of the Asian common platform of currency/bond settlement system.

Table 3. Portfolio Investment between the US and Asia (2009:billion \$)

	From East Asia to East Asia (China)	From U.S. to East Asia (China)	From East Asia to U.S.	From Japan to East Asia
<b>Equities</b>	320 (175)	882 (102)	298	48
<b>Long-Term Bonds</b>	108 (10)	59 (0.7)	789	21

# (Note) Importance of prevention of Sharp Yen Appreciation

1. Japan has suffered persistent deflation after sharp appreciation of Yen in 1995: Two causes of Japan's deflation

(1) Decline of natural interest rate (lower expected growth due to population and labor market structure changes)

(2) Self-fulfilling deflation expectation arising from expected appreciation of Yen

2. Recent moves by the BOJ in February and April are appropriate to attain 1% inflation goal, given the experience of QE1 (March 2001-March 2006) and massive intervention in the period from spring 2003 to spring 2004.

3. In order to eradicate deflation, we should be cautious on the choice of price index (chain index excluding foods and energy) and watch carefully nominal wage/price-unemployment (GDP gap) nexus ( Fig.9,10,11).

4. It is required to raise "1% goal for the time being" to 1-2% or 2% if the BOJ intends to support the economic growth strategy by the government (2% in real and 3% in nominal GDP)



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